FHFA's Conservatorship Priorities for 2013

Remarks as Prepared for Delivery

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Thank you for inviting me to speak this afternoon. Over four years ago Fannie Mae and Freddie Mac, or as I will refer to them, the Enterprises, were placed into conservatorships. In those intervening years we have seen conditions in the housing market as well as the financial condition of the Enterprises stabilize. At the same time the single-family mortgage market remains almost entirely supported by the Federal government, and the timing of broader housing finance reform remains uncertain.

Today I will provide a brief review of current housing market conditions and the evolution of the conservatorships of Fannie Mae and Freddie Mac. I will then describe FHFA's conservatorship priorities for 2013, with a focus on steps the Enterprises will be taking to contract their operations and build a new secondary market infrastructure.

Housing Market Conditions

Let me start today with a brief review of trends in the housing market. We are seeing signs of recovery across a number of dimensions and, while the marketplace is by no means normalized, conditions are promising in many ways. Certainly, mortgage rates remaining at historic lows as a result of Federal Reserve actions have contributed to the recovery.

Nationally, perhaps the most notable area of strength is increased housing demand, which has resulted in a reduction in housing inventories. According to the latest data from the National Association of Realtors, the inventory of homes available for sale was only 1.7 million units in January. Given that the annualized rate of home sales during that month was nearly 5 million properties, this represented only about 4.2 months' worth of supply. Just a year earlier, the relative supply was a still-modest 6.2 months. And at its peak—in July 2010—the supply was 12.1 months' worth available for sale.

While substantial, *shadow* inventory today is significantly below prior years. The latest CoreLogic information, which includes data for October, indicates that shadow inventory dropped roughly 12.3 percent between October 2011 and October 2012. This decline represented a reduction in the shadow inventory pool of about 300,000 units.

As we recently reported, home prices have increased over the latest year. According to the FHFA index, national home prices grew 5.5 percent between the fourth quarters of 2011 and 2012. This increase leaves the FHFA index about 15.5 percent below its peak. While other home price data suggest that we remain further below the peak, the other metrics tell the same story about the recent upward trend in home prices.

With the increase in home prices, home starts have accelerated over the last year. Census data from December 2011 estimated the seasonally adjusted annualized rate of starts to be about 700,000 units. By September 2012, that rate had grown to roughly 840,000 units and, in January, the rate was estimated at 890,000 units. This compares to a low of about 480,000 units in April 2009, and is 61 percent of the long-run average.

The housing downturn also shifted consumer demand patterns away from home purchases and toward renting. Rental rates have climbed steadily over the last year and vacancy rates have tightened further. With regard to the latter—in the Census Bureau's Fourth Quarter Vacancy Report, the rental vacancy rate was 8.7 percent, a full two percentage points below the rate in the fourth quarter of 2009. Along with the decreases in vacancy rates, we have seen increased interest in the conversion of single-family properties to rentals.

While these are positive developments, strong national and local headwinds still exist. Indeed, despite recent improvements, it is hard to say the markets are fully normalized.

For example, according to the Mortgage Bankers Association, the share of mortgages that were past due in the third quarter was 7.4 percent. Although this rate is more than two percentage points below its peak, it was still well above a healthy level. Similarly, the share of borrowers who are underwater has fallen materially, aided by recent increases in home values, but the problem still exists in a number of geographic areas. According to CoreLogic estimates, which account for all homeowners with all types of mortgages—not just Fannie Mae and Freddie Mac mortgages—more than four out of ten borrowers remain underwater in Florida and more than half are underwater in Nevada. Conditions in such areas—and a few others—of course are not aided by the fact that unemployment rates remain high and income growth is sluggish at best in these areas.

Normalization of localized markets is also hindered in many cases by the backlog of shadow inventory and extremely lengthy foreclosure timelines. With foreclosure timelines measured in *years* in states like Florida, New York, and New Jersey, much of the supply of homes that *should be available for sale* is locked up. In these states, where the market has not been allowed to clear, house price growth has also lagged the national average. For example, compared to a national increase of 5.5 percent over the last year, house price growth in New York was 1.3 percent, and house prices declined in New Jersey by 0.6 percent.

Finally, in states where supply has been limited, we have seen the somewhat perverse result of home building activity *expanding* in 2012 while a considerable backlog of homes languished in the foreclosure pipeline. For example, building permits data from the National Association of Home Builders indicate that permit activity was up in 2012 in New York, New Jersey, and Florida.

Housing Finance and the Conservatorships of Fannie Mae and Freddie Mac

Despite some signs of normalization in the housing market, our Nation finds itself in the uncomfortable position of having over 90 percent of new mortgage originations supported by the Federal government. That support is provided directly through government loan programs like the Federal Housing Administration (FHA), and through the financial support that the Treasury Department provides to maintain the solvency of Fannie Mae and Freddie Mac.

So how did we get here? I could spend a considerable amount of time going through the issues that led to the collapse of the housing market. There were certainly issues with relaxed credit standards, the level of regulatory oversight, lack of market discipline, lack of transparency, and borrowers overextending their credit positions. But in general, as the housing downturn picked up speed and mortgage delinquencies began to rise in 2008, the private securitization market shut down. This led to the reliance on the Enterprises and FHA as the primary source of mortgage credit.

Of course the Enterprises were not immune to the dislocation in the housing market. As we moved through 2008, Fannie Mae and Freddie Mac could no longer access new equity capital, and questions about their ability to meet their debt and guarantee obligations began to surface. To avoid the potential systemic consequences of an Enterprise default, both in terms of broader losses to the financial system and access to new credit, FHFA placed the Enterprises into conservatorships on September 6, 2008. At the same time, the Treasury Department entered into financial support agreements -- the Senior Preferred Stock Purchase Agreement or PSPAs – to provide market confidence that the Enterprises would be able to meet their obligations. Since that time FHFA has overseen the largest, most complex conservatorships in history.

Broadly speaking, as conservator FHFA is responsible for taking actions necessary to put the Enterprises in a sound and solvent condition; and preserving and conserving the assets of the Enterprises. FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this “preserve and conserve” mandate directs FHFA to minimize losses on behalf of taxpayers.

In 2008, the immediate objectives of conservatorship were to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. Because the private mortgage securitization market had already retreated and there were no other effective secondary market mechanisms in place, the Enterprises’ continued operations were necessary for most Americans to obtain a mortgage or refinance an existing mortgage.

As operations were stabilized, I would characterize the second phase of the conservatorships as focusing on developing tools for the Enterprises to reduce losses on their legacy credit exposures. This effort was also consistent with FHFA’s other statutory responsibilities to provide assistance to borrowers. FHFA also clarified that the Enterprises would be limited to continuing their existing core business activities. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

Since being placed into conservatorships, the Enterprises have focused extensively on loss mitigation and borrower assistance activities, which include:

- Completing 2.6 million foreclosure prevention transactions, this included 1.3 million loan modifications.
- Providing for the refinancing of 14.4 million loans. Included in this total is 2 million refinances through the Home Affordable Refinance Program, or HARP, which provides refinance opportunities to borrowers with little or no equity in their home.

In addition to loss mitigation efforts, the Enterprises have moved into a more stable financial position as the credit quality of new business has improved. For example, loans with Alt-A characteristics, interest-only features, and to borrowers with low credit scores are close to zero in the Enterprises' new credit guarantee book. Average credit scores across the new book have increased by over 35 points.

Overall in terms of financial performance, as the credit exposure from the Enterprises' pre-2008 credit book is resolved and reduced, and as new business becomes a larger portion of the Enterprises' credit exposure, there was little or no need for further Treasury draws in 2012, and the Enterprises generated positive net income for 2012.

In short, while there still is legacy credit exposure to work through, the second phase of the conservatorships put in place the loss mitigation infrastructure to address those issues, and the new business operations have greatly improved. But that still leaves us with a mortgage market that is reliant on Federal support, with very little private capital standing in front of the Federal government's risk exposure.

FHFA's 2012 Strategic Plan for the Operation of the Enterprise Conservatorships

That brings me to FHFA's Strategic Plan for the operation of the Enterprise conservatorships that was issued in February 2012.

As part of the backdrop to issuing the Strategic Plan, there seems to be broad consensus that Fannie Mae and Freddie Mac will not return to their previous corporate forms. The Administration has made clear that their preferred course of action is to wind down the Enterprises. Of the various legislative proposals that have been introduced in Congress, none of them envision the Enterprises exiting conservatorship in their current corporate form. In addition, the recent changes to the PSPAs, replacing the 10 percent dividend with a net income sweep, reinforces that the Enterprises will not be building capital as a potential step to regaining their former corporate status.

In the face of this uncertain future, FHFA set forth three broad goals in the Strategic Plan that will define the focus of the conservatorships for the next few years:

1. **Build.** Build a new infrastructure for the secondary mortgage market.

2. **Contract.** Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.

3. **Maintain.** Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

We also embedded various activities associated with these components in a Conservator's Scorecard in 2012 to focus the activities of the Enterprises. We made considerable progress in 2012 which brings me to the priorities for executing on the Strategic Plan in 2013. Today we are issuing the Conservator's Scorecard for 2013 that reflects priorities for the rest of this year for each of the goals.

Contract

Let me start with contract. The basic premise is that with an uncertain future and a general desire for private capital to re-enter the market, the Enterprises market presence should be reduced gradually over time.

In 2012, guarantee fees were increased twice, which now brings the average guarantee fee on new mortgages to around 50 basis points, approximately double what guarantee fees were prior to conservatorship. A key motivation behind increasing Enterprise guarantee fees is to bring their credit risk pricing closer to what would be required by private sector providers. However, the increase in guarantee fees is part of the contract framework; it is not designed primarily to increase the Enterprises' revenue. The idea is that at some point the increases in guarantee fees will encourage private capital back into the market. We are not there yet, but in conversations with market participants, I think we are getting closer. We also set some goals in 2012 of executing on risk sharing transactions. While we did not execute any transactions, a considerable amount of preparatory work was done to lay the groundwork for 2013.

To move the contract goal forward, we set forth three priorities in the 2013 Scorecard.

First, in the single-family credit guarantee business we have set a target of $30 billion of unpaid principal balance in credit risk sharing transactions in 2013 for both Fannie Mae and Freddie Mac. We have specified that each Enterprise must conduct multiple types of risk sharing transactions to meet this target. For example, we expect to see transactions involving: expanded mortgage insurance; credit-linked securities; senior/subordinated securities; and perhaps other structures. The goal for 2013 is to move forward with these transactions and to evaluate the pricing and the potential for further execution in scale. What we learn in 2013 will set the stage for the targets for 2014, and I fully expect to move from a dollar target to a percentage of business target at some point in the future.

While it is not a Scorecard item, we also expect to continue increasing guarantee fees in 2013, and the execution of the single-family risk sharing transactions I just described should provide valuable information as to how close current guarantee fee pricing is to where private capital would be willing to absorb credit risk.

Second, the multifamily business presents a different set of issues. Unlike the single-family credit guarantee business, the Enterprises have a smaller market share and there are other providers of credit in the multifamily market. The Enterprises' market share of new multifamily originations did increase during the financial downturn, but in 2012 it returned to a more normal position.

Another difference from the single-family business is that each Enterprise's multifamily business has weathered the housing crisis and generated positive cash flow. In contrast to their common approach to their single-family businesses, Fannie Mae and Freddie Mac do not take the same approach to their multifamily businesses. Each approach also already embeds some type of risk sharing. For a significant portion of its business, Fannie Mae shares multifamily credit risk with loan originators through its delegated underwriting program. For a significant and increasing portion of its business, Freddie Mac shares multifamily credit risk with investors by issuing classes of securities backed by multifamily mortgages where the investor bears the credit risk.

Given that the multifamily market's reliance on the Enterprises has moved to more normal range, to move forward with the contract goal we are setting a target of a 10 percent reduction in multifamily business volume from 2012 levels. We expect that this reduction will be achieved through some combination of increased pricing, more limited product offerings, and tighter overall underwriting standards.

Finally, the retained portfolios of the Enterprises have been on steady decline since 2009. The initial PSPAs included a 10 percent annual reduction, and the most recent changes to the PSPAs increased the annual reduction to 15 percent. The composition of the Enterprises' retained portfolios has also changed significantly since the establishment of the conservatorships. Prior to conservatorship, the retained portfolios were dominated by their own mortgage-backed securities and performing whole loans. As those securities have been paid down, and as the need to work through delinquent loans increased, the retained portfolios changed from being relatively liquid to being less liquid.

To address this issue and further "de-risk" the Enterprises' retained portfolios in 2013, we are setting a target of selling 5 percent of the less liquid portion of their retained portfolios, in other words their retained portfolios excluding agency securities. Given that natural run-off in the retained portfolios would have likely hit the PSPA reduction targets in the next few years, and that the Enterprises are not actively purchasing new assets for their retained portfolios, this added requirement to sell from the less liquid portions of their retained portfolios should lead to an even faster reduction than is required under the PSPAs.

Build

Moving on to the build goal, the basic premise is that the Enterprises' outmoded proprietary infrastructures need to be updated and maintained, and any such update should provide enhanced value to the mortgage market with a common and more efficient model. The Enterprises' infrastructures are not the most effective when it comes to adapting to market changes, issuing securities that attract private capital, aggregating data, or lowering barriers to market entry. In short, there must be some updating and continued maintenance of the Enterprises' securitization infrastructure, and to the extent possible, we should invest taxpayers' dollars to this end once, not twice.

We also have undertaken this effort with the goal that it will have benefits beyond the Enterprise business model. Therefore, this new infrastructure must be operable across many platforms, so that it can be used by any issuer, servicer, agent, or other party that decides to participate.

To move this effort forward and gather input from the industry, FHFA issued a white paper in October 2012 on the build goal, which includes the development of a common securitization platform and a model contractual framework. One of the most important issues we raised in the white paper was the scope of the securitization platform. One approach we outlined is that the focus of the platform could be on functions that are routinely repeated across the secondary mortgage market, such as issuing securities, providing disclosures, paying investors, and disseminating data. These are all functions where standardization could have clear benefits to market participants.

To move this project forward in 2013, we are announcing as part of the 2013 Scorecard that a new business entity will be established between Fannie Mae and Freddie Mac. We believe that setting up a new structure that is separate from the two companies is important for building a new secondary mortgage market infrastructure. Our objective, as we stated last year, is for the platform to be able to function like a market utility, as opposed to rebuilding the proprietary infrastructures of Fannie Mae and Freddie Mac. To make this clear, I expect that the new venture will be headed by a CEO and Chairman of the Board that are independent from Fannie Mae and Freddie Mac. It will also be physically located separate from Fannie Mae and Freddie Mac. Importantly, we plan on instituting a formal structure to allow for input from industry participants.

What I have just described is the governance and ownership structure for the near-term phase of the platform. It will be initially owned and funded by Fannie Mae and Freddie Mac, and its functions are designed to operate as a replacement for some of their legacy infrastructure. However, the overarching goal is to create something of value that could either be sold or used by policy makers as a foundational element of the mortgage market of the future.
We are designing this to be flexible so that the long-term ownership structure can be adjusted to meet the goals and direction that policymakers may set forth for housing finance reform.

In the October white paper we also put forth some broad ideas on creating a model contractual framework. Similar to the securitization infrastructure effort, the focus of this effort is to identify areas where greater standardization in the contractual framework would be valuable to the mortgage market of the future.

FHFA's alignment efforts, under which FHFA, Fannie Mae, and Freddie Mac work collectively to modify, enhance, and improve Enterprise programs and practices, will continue in 2013. Much can be learned from these efforts, but given that the ultimate outcome of housing finance reform remains uncertain, this is an optimal time to further consider how best to address contractual shortcomings identified during the past few years. Much work has already been done in this area by market participants, including the American Securitization Forum's Project

Restart and additional input will be exceptionally valuable. As the Enterprises move forward with risk sharing transactions, the development of transactional documents will provide a real time test of a new standardized contractual framework for transactions where the private sector is absorbing credit risk.

Another aspect of build is the Uniform Mortgage Data Program or UMDP. This effort may get overlooked at times, but a solid foundation of data standards is vitally important regardless of the future direction of housing finance reform. I am very encouraged by this effort as the Enterprises have worked through an industry process set up through MISMO – the Mortgage Industry Standards Maintenance Organization -- to move this process forward. Much work has already been accomplished through the development of a Uniform Loan Delivery Dataset and a Uniform Appraisal Dataset. Work is beginning on the Uniform Mortgage Servicing Dataset. This latter effort will take time, but working through the process with a broad-based coalition of industry partners in MISMO should serve as a model for future efforts as we seek to rebuild the foundation of the mortgage market. In the end the benefits are immense. Developing standard terms, definitions, and industry standard data reporting protocols will decrease costs for originators, servicers and appraisers and reduce repurchase risk.

Maintain

Finally, in 2013 we seek to make further progress on the third strategic goal, maintaining foreclosure prevention activities, and promoting market stability and liquidity. As I noted earlier, foreclosure prevention efforts were extensive in 2012 as FHFA and the Enterprises continued to simplify, streamline, and improve existing programs. In 2012, we saw improvements as the changes made to HARP took effect. Some highlights of those changes include: expanding the program to greater than 125 loan-to-value ratio; clarifying representation and warranty exposure; and incenting shorter-term refinance opportunities through reduced pricing. The results have been impressive:

- The volume of total HARP refinances in 2012 has almost doubled from the number of HARP refinances prior to 2012.
- HARP refinances with greater than 105 loan-to-value ratios made up 43 percent of total HARP refinances in 2012, compared to 15 percent in 2011.
- HARP refinances into a shorter-term mortgage made up 18 percent of total HARP refinances in 2012 for underwater borrowers, compared to 10 percent in 2011.

Another maintain priority was initiated in September 2012 when FHFA and the Enterprises announced the start of fundamental changes to the representation and warranty framework, which will eventually move the process to more upfront monitoring. The goal of these changes is to improve the credit risk management practices of the Enterprises, and provide more certainty to originators as they make decisions on extending credit. The priorities for 2013 include:

- Enhancing the post-delivery quality control practices and transparency associated with the new rep and warranty framework.
- Working to complete rep and warranty demands for pre-conservatorship loan activity.

Let me close by highlighting a couple of other 2013 priorities. One will be the near-term efforts regarding mortgage insurance to update master policies and formulate eligibility standards. While this effort can be looked at as maintaining credit availability, it also seeks to strengthen and clarify standards to increase the reliability of this form of credit enhancement. This will be a needed step for mortgage insurance to remain a viable risk transfer mechanism in the future.

Another area to note is our effort to develop a set of aligned standards for force placed insurance. Issues associated with force placed insurance cover a wide spectrum, which include conditions in local insurance markets, sound credit risk management practices, and consumer protection. From our perspective, we could have initiated any one of a variety of Enterprise-centric approaches, ranging from self-insurance to purchasing insurance directly to developing other structures to obtain insurance. Those options would have done little if anything to address how a future mortgage market without the Enterprises would address force placed insurance. Therefore, we have taken a pause in pursuing an Enterprise-centric approach. We plan to bring together a wide range of stakeholders to further analyze how standards can be set that could more broadly be applied to the mortgage market, which is in line with the approach we took with the Servicing Alignment Initiative. This broadened approach will also enable greater regulatory coordination in an effort to consider the various issues associated with force placed insurance.

Conclusion

In closing, thank you again for inviting me here today. It is time that policy makers move on with formulating the role of the government in the mortgage market of the future. The steps I have outlined today in regard to moving forward on the Strategic Plan in 2013 should help to set the stage for whatever transition policy makers set forth.